Perpetual Growth Machine

While Costco shares aren't cheap, value investor Nicholas Sleep shares some fascinating insights about the company and makes an excellent case for its long-term prospects.

Value investors have long been intrigued by Costco Wholesale Corp. It has a fabulous long-term record of steady growth, it's old-school in its management and compensation practices, Berkshire Hathaway's Charlie Munger is on the board – plus, any bargain hunter loves to shop there. Not so many value investors own the stock, however, in part because it has extremely low margins – less than 2% after tax – and the stock rarely looks cheap, trading today at 24x trailing earnings per share.

So we didn't expect anything particularly new when we sat down to read the discussion of Costco in the annual letter of Nicholas Sleep of London's Marathon Asset Management. But Sleep's fresh insights, arguments and analysis – "Mungeresque" in tone and content – persuaded us that Costco's intrinsic value is probably quite a bit higher than we'd thought. We followed up with him to learn more on why he believes, even if it's not a 50-cent dollar, Costco is an outstanding long-term investment.

Customer really is king

Retailers love to boast that the "customer is king," but none live it like Costco. It starts with how the company negotiates with suppliers. As Sleep notes:

"Costco's key to negotiating terms is that the number of items in a store (SKUs) is fixed at around 4,000, with those suppliers that provide the best value proposition to the consumer winning space on the shop floor. Contrast this to normal industry practice, where the supermarket assumes the role of landlord, auctions space to the highest bidder and pockets the rents ("slotting fees" in industry parlance). Many supermarkets make their money from buying from the supplier. Costco makes money from selling to the consumer."

Costco fixes its retail prices at a maximum of only 14% over the company's cost – with no exceptions. This pricing discipline – even Wal-Mart's mark-ups are around 20% – engenders outstanding customer loyalty. As the company has raised its annual membership fee over time, to $45, membership renewal rates have barely budged from an enviable 86%.

The real power of Costco's strategy – and the source of its competitive advantage, according to Sleep – is how the benefits of growth are reinvested in the relationship with the consumer. As Costco opens new stores, supplier and other scale cost savings are passed back to customers through even more compet-

INVESTMENT SNAPHOT

Costco Wholesale Corp.
(Nasdaq: COST)

Business: Membership warehouse retailer offering members low prices on limited selection of branded and private-label products across multiple product categories. Primary operations in U.S. and Canada.

Share Information
(@2/18/05):

Price	**45.80**
52-Week Range	35.05 - 50.46
Dividend Yield	0.9%
Market Cap	$21.64 billion

Short Interest:
(@1/10/05)

Shares Short/Float	2.47%

Financials (TTM):

Revenue	$49.16 billion
Operating Profit Margin	2.91%
Net Profit Margin	1.86%

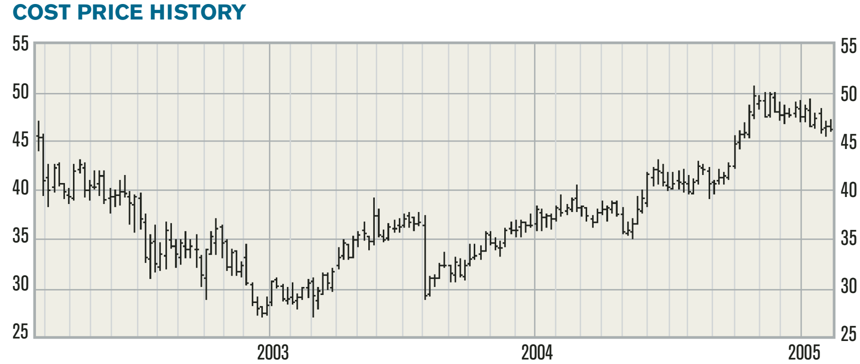
Valuation Metrics:
(Current Price vs. TTM)

	COST	S&P 500
P/E	23.9	23.1
P/CF	15.8	13.9

Largest Institutional Owners:

Company	% Owned (@ 9/30/04)
Davis Selected Advisers	7.9%
Barclays Bank Plc	3.6%
State Street Corp	2.7%
Capital Guardian Trust	2.3%
Vanguard Group	2.2%

COST PRICE HISTORY



THE BOTTOM LINE

Costco's "perpetual machine" of growth is capable of keeping company revenue and cash flow growing 13% annually, says Nicholas Sleep of London's Marathon Asset Management. If the market price reflected even a 10% growth expectation, he says, COST would trade at $62, a 35% premium to the current market price.

Sources: Company reports, other publicly available information itive prices. Customers then respond to the better prices, driving incremental revenue at both new and old stores. As Sleep writes:

"In the office we have a white board on which we've listed the very few investment models that work and that we can understand. Costco is the best example we can find of one of them: scale efficiencies shared with customers. We often ask companies what they would do with windfall profits, and almost no one replies 'give it back to customers'. How would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today's static assessment of performance. It is managing the business to raise the probability of long-term success."

PRIVILEGES OF MEMBERSHIP

Costco's membership-only model helps foster a unique relationship with its customers. People shop there because it's Costco, not because it stocks Pepsi or Pampers. As Costco has raised its basic annual membership fee over time, to $45 currrently, membership renewal rates have barely budged from an enviable 86%.

By sharing the cost savings of growth, Costco earns revenues per square foot – around $830 – that are the envy of the industry. Wal-Mart's Sam's Club checks in at around $500 per square foot, while BJ's Wholesale Club is about $400. Even more importantly, Sleep estimates that mature Costco stores – open at least five years – generate revenue of over $1,000 per square foot.

Margin trouble?

Costco's pricing discipline, by definition, keeps margins low – at 1.9%, they are roughly half those of Wal-Mart (3.6%) and Target (4.1%). Sleep argues that Wall Street's focus on margins is short sighted:

"True, the company has low margins, but that's the point. The firm is deferring profits today in order to extend the life of the franchise. Of course Wall Street would love profits today, but that's just Wall Street's obsession with short-term outcomes. The firm could earn Wal-Mart margins by taking pricing up a little and the stock would then trade at 11x earnings, but would it be a better business as a result? We think not, because it might allow the competition to catch up."

Contributing to margin pressure in recent years has also been a rise in SG&A costs as a percentage of revenues, fueled in large part by spending on a new warehousing and distribution system and rising employee wages and benefits. A sign of trouble? No, explains Sleep: "We clearly differentiate between 'good' and 'bad' SG&A spending," he says. "In both of these cases, Costco is investing in areas critical to its growth." With the new warehousing system in place, efficiency gains will start showing up in the financials this year. And the slightly higher wage base helps Costco retain its employees twice as long as competitors do, which Sleep sees as positively impacting customer service and contributing to its very high customer retention.

Still an early life-cycle company

Even with annual sales of nearly $50 billion, Sleep makes a compelling case for Costco as a growth company, through geographic expansion, increased market penetration, and the virtuous cycle of growth in maturing-store asset turns as scale efficiencies result in even lower prices.

"One-third of the store base remains in California, and almost half on the West Coast. Management always confesses to underestimating saturation. In Los Angeles, for example, after merging with Price Club in 1993, Costco thought 31 stores were too many for the market, but today there are 36. Likewise, in Seattle and Alaska, the penetration of membership cards is an astonishing 65% of households, but in most markets it is below 10%."

All told, Sleep estimates that Costco can conservatively increase revenue and free cash flow by 13% per year into the foreseeable future – 4% from the increasing asset turns of newer stores as they mature, 4% from same-store growth at already-mature stores, and 5% from new stores.

"This is an early life-cycle company whose competitive moat gets deeper as the company gets bigger and the consumer is consistently cut-in on the benefits of the company's growth," Sleep says, terming this cycle a "perpetual machine" of growth.

The market, which currently prices Costco shares at around $46, is not so generous in its growth expectation. Sleep calculates that if Costco shares were priced to reflect just 10% annual growth, the stock would trade at $62 today. Even at that price he wouldn't sell, he says, given his expectation for even faster growth.

What could go wrong? Wal-Mart, with Sam's Club, could mount a sustained direct attack to undercut Costco's prices. Sleep considers that unlikely, as Costco has shown itself more than capable of competing head-to-head with the discounting giant. The departure of CEO James Sinegal, 68, the architect of Costco's unique and disciplined culture, could also be a blow. Sleep points out that Sinegal shows no sign of slowing down, and that Costco's experienced board can be counted on to appoint a worthy successor.

We'll leave to Marathon's Nicholas Sleep the final word on Costco: "The consensus has it that Costco is a low-margin retailer with an expensive stock and a cost problem. That is certainly one description. But in our judgment it is a cost-disciplined, intellectually honest, high-product-integrity, perpetual motion machine trading at a discount to value." VII

O’Reilly and the Retail Auto Parts Business

by John Huber | Mar 1, 2017 | Investment Journal | 5 comments

This post is just an outline on why I like the business, and why it’s on our watchlist. Here are some things to like about O’Reilly:

- High returns on capital
- Durable, recession-proof business
- Steady and predictable free cash flow
- Big lead in commercial (“DIFM”) business
- Distribution network that is positioned for growth
- Long growth runway

The After-Market Auto Parts Business

The retail auto parts business is a pretty good business, and in my opinion probably one of the best businesses in all of retail. The top players in the industry have shown a surprising amount of resiliency against the threat of online retail (although this threat is growing).

O’Reilly sells auto parts to people who want to fix their own cars as well as to mechanics who fix cars for their customers. The “DIY” segment represents about 58% of the business, with the commercial business (the so-called “do-it-for-me”, or “DIFM”) making up the other 42%.

O’Reilly is one of the top players in a consolidating industry. There are around 35,000 auto parts stores in the US. The top three players control roughly 15,000 of those stores, but the tenth largest chain has fewer than 100 locations, and the bottom half of the industry is extremely fragmented (mostly mom and pops and very small family-owned chains):

Top Ten Auto Parts Chains

1. **AutoZone Inc. (5,717)**
2. **Advance Auto Parts (5,211)** [1]
3. **O’Reilly Auto Parts (4,660)**
4. **Genuine Parts/NAPA (1,100)** [1]
5. **Pep Boys (803)**
6. **Fisher Auto Parts (489)**
7. **Autoplus / Uni-Select (267)** [1]
8. **Replacement Parts (160)**
9. **Auto-Wares (158)**
10. **Automotive Parts Headquarters (99)**

Given the attractive returns on capital that can be earned by buying out Mom and Pop, rebranding the store, and increasing sales with a much more efficient distribution model, it’s almost certain that the industry will continue to consolidate. Unlike many businesses that “rollup” various competitors in their business, O’Reilly and its competitors have generally used its sizable free cash flow to finance growth.

Let’s review some of the reasons why I like O’Reilly’s business:

High Returns on Capital

O'Reilly had about $1.7 billion of capital invested in the business ten years ago. Currently, there is about $3 billion invested (I'm defining capital as the net working capital plus net fixed assets). During this decade, operating income grew from $300 million to $1.7 billion. So this incremental capital investment of $1.3 billion has led to $1.4 billion in incremental pretax earning power, a pretty remarkable return on capital. Part of this has been fueled by removing working capital from the business through better payables terms, but the unit economics of this business are outstanding, with very solid cash on cash returns for each new store that is opened. These high returns on incremental capital investments in the form of new stores combined with a long-growth runway creates a nice compounding effect over time.

Durable Business

The auto parts retailers are very defensible businesses that have proven to do quite well during economic downturns. Fixing your car is a must, and whether you do it or your mechanic does, the overall economy is not a deciding factor. You need your car, and you likely need it back in a day or two. Also, economic downturns can actually be somewhat of a boon for these companies as many people postpone buying a new car during recessions, which means that the average age of cars as a whole increases, and as cars age, they break. O'Reilly benefits from a population of cars older than five years old (typically the age when the dealer warranties expire). This cohort of vehicles often increases during recessions, which benefits the auto parts business. O'Reilly and others did very well during the last recession, when new car sales plummeted from 17 million to 10 million per year at the nadir.

Free Cash Flow

The business produces a lot of operating cash flow. Some of this has been used to finance the company's growth plans. O'Reilly's growth capital expenditures could be divided into three main categories, acquiring smaller competitors, increasing its store footprint by opening new locations, and building out its distribution network.

The company produces enough cash flow to finance all of its growth needs, and historically has used its excess cash flow to buy back stock. One of the advantages O'Reilly has over its competitors is that it has spent the past decade or so investing in the distribution network, and so going forward the company should produce excess free cash flow, which means accelerating buybacks.

Commercial Business

O'Reilly gets 42% of its sales from commercial business, and this business has been growing over time at a slightly faster pace than its retail business. There are a few reasons to like the commercial business, but one I'll mention here is that it's more insulated from ecommerce competition. The mechanic makes money by moving cars through his bays at as fast a rate as possible. Speed is absolute crucial to his business. The more cars he moves through his bays, the more money he makes. So the mechanic is less worried about the absolute cheapest price for the part, and much more concerned with how quickly he can get the part to put in the car. He largely passes the cost of the part on to the customer anyhow.

O'Reilly's distribution network ensures that they can get the part to the mechanic in a very short period—often in just a few hours—and this is usually the deciding factor for where the mechanic decides to source his parts. Also, there is a stickiness factor to this business from a service perspective. The mechanic is very busy, and doesn't have a lot of extra time to do price comparisons. He also doesn't have a real desire to switch his relationship with his sales rep. Most mechanics have their parts guy on speed dial and have a system for ordering parts that makes this part of the mechanic's business as easy as possible. The effort it would take to switch this setup would likely cause an unwanted headache, and at least temporarily, would interrupt business.

I also think more and more people are getting their cars worked on by a professional rather than trying to fix it themselves. The dealers get a lot of this business, but with the average age of a car on the road over 11 years old now (and well-past any new-car warranty periods), the mechanics will still get a big piece of this pie.

Distribution Network

The company's distribution centers (DC's) are large warehouses that deliver parts to smaller "hub" stores and also the main retail stores. O'Reilly's DC network is much more established than its competitors, with 26 DC's and nearly 300 mini-hubs (locations that are larger than traditional stores with around 44,000 SKU's but act as a mini-warehouse for other nearby locations). O'Reilly has spent the better part of the last decade building out this distribution network, which looks like a wise decision, as competitors like Autozone spent their cash flow buying back stock (note: this has worked out very well for AZO shareholders, and it wasn't a poor use of capital, but it has created a situation where AZO is now forced to play "catchup", as O'Reilly has by far the best distribution network in the business with much greater capacity and much better positioning for store growth).

Growth Runway

As mentioned above, the auto parts retail business is very fragmented. Just like big box home improvement stores slowly but steadily consolidated a fragmented collection of individual hardware stores over the past few decades, a similar dynamic exists in auto parts retail shops. Owning a small auto parts store is a fairly capital intensive business. If you are a small shop owner, you lack the buying power to garner attractive terms from your suppliers, and so you have to tie up a lot of working capital in your store's inventory. Financing your inventory with your own cash (or debt) makes your business much more capital intensive. It lowers your store's return on capital, but more importantly from the shop owner's perspective, it means more of your cash has to effectively remain tied up on the store shelves.

Charlie Munger once lamented this dynamic when he owned a heavy machinery dealership that sold Caterpillar-type equipment. He commented how every year they'd sell enough equipment to make a profit, but all of profit ended up sitting out in the yard, tied up in the next year's inventory.

Large players like O'Reilly achieve attractive terms from their suppliers (in the form of longer "days payables") which means that big players like O'Reilly and Autozone are now to the point where their inventory is completely financed by its payables. This dramatically increases the company's capital efficiency because it removes billions of dollars' worth of capital requirements for O'Reilly. The company's $2.9 billion in accounts payables more than offsets its $2.8 billion in inventory, which frees up cash to be used to invest in new stores, make acquisitions, or return cash to shareholders through buybacks.

As O'Reilly has grown, it has steadily extracted better and better terms from its suppliers:

Efficiency	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Days Inventory	220.62	229.63	252.21	258.76	247.91	252.15	258.79	256.53	248.79	241.74
Payables Period	91.01	104.68	112.6	112.65	134.49	189.81	221.75	232.79	241.1	247.78
Cash Conversion Cycle	145.03	137.72	152.29	158.1	125.63	73.7	47.45	34.14	17.93	4.87

As O'Reilly's scale and buying power has increased, payables as a percentage of inventory have steadily climbed over the past decade, and its cash conversion cycle (the amount of time (in days) it takes for the company to turn its investment in inventory into cash flow) has plummeted. A decade ago, O'Reilly had a cash outlay, let's say, of $100 or so for an alternator to put on its shelf for sale. In 2007 it took 145 days between the time O'Reilly shelled out this $100 and the time it got back its cash for the sale of this alternator. A decade later at the end of 2016, this period of days—thanks to better and better terms from suppliers—had shrunk from 145 to 4.

O'Reilly gets its suppliers to finance (in the form of longer payables periods) what smaller retailers have to pay cash for.

There are also another few key points that make the business more attractive for larger players with better economies of scale:

1. **Sizable Store-Level Inventory Investments**

O'Reilly has around $575,000 worth of inventory in each store, spread across 23,000 SKU's. Mom and Pop certainly have a much narrower selection and likely a smaller total value of inventory in their stores, but auto parts retail is a business that requires a fair amount of stock on the shelves in order to adequately service the customer. Cars are complicated machines with many thousands of parts—all of which can break and will need replacement.

The distribution network of O'Reilly means that they can stock a very limited number of each SKU in each store (since the company can quickly replace each item sold with a quick shipment from one of its many "hubs" or warehouses). Smaller competitors need to carry a "deeper bench" (more than one or two of each SKU), given their more limited inventory management system. This means smaller competitors have a more difficult time matching the breadth of O'Reilly at the store level (since more shelf space has to be tied up with redundant SKU's at the smaller stores).

2. **Slow Inventory Turns**

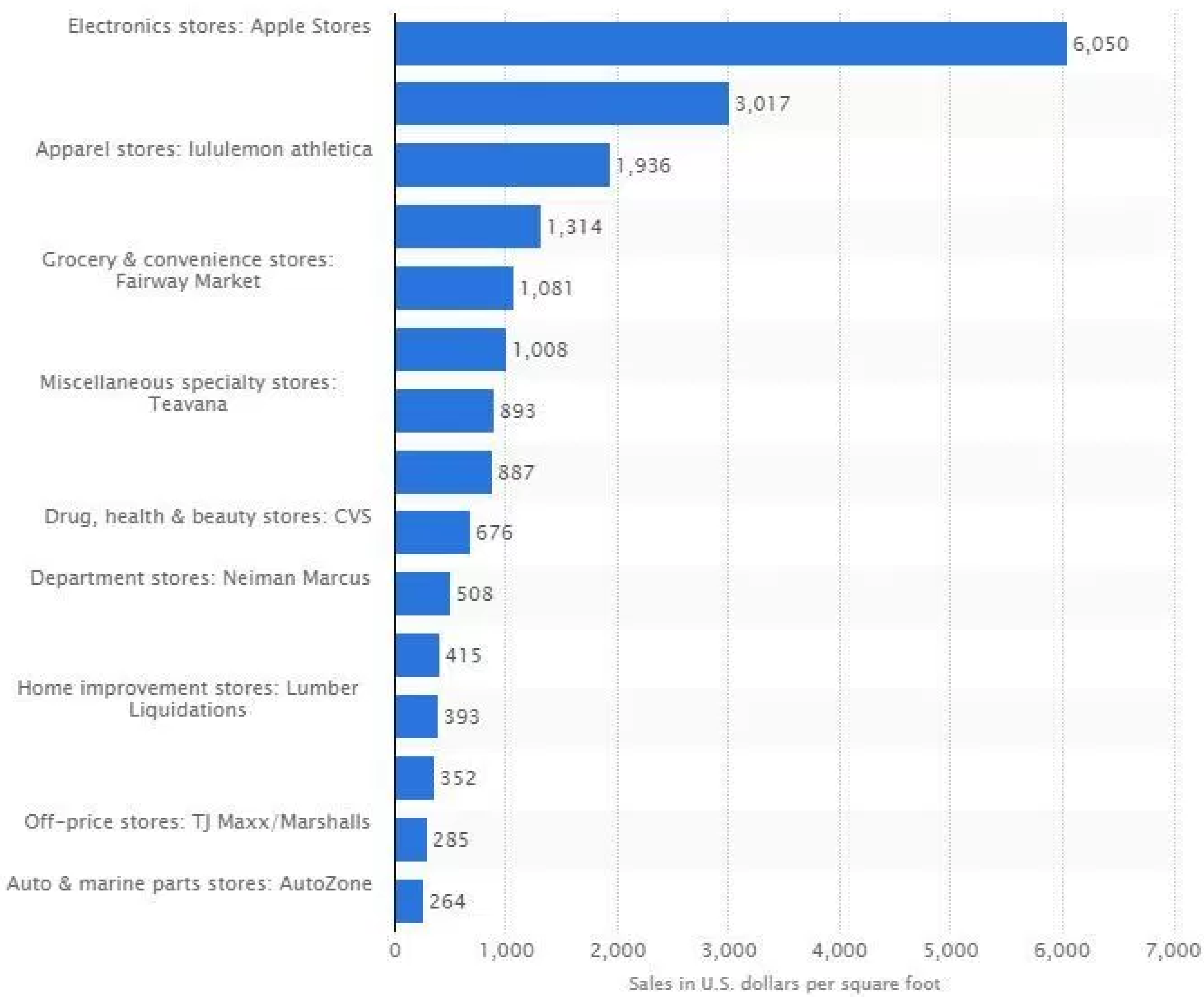
Not only do the smaller competitors have to put up a sizable amount of capital to stock their shelves, but the auto parts retail business has a very low "turnover" rate. This means that on average, each part sits on the shelf for a relatively long time before someone comes in and buys it. It takes about 8 months for O'Reilly to turnover its inventory. This is likely even slower at smaller competitors.

Low turnover is not in and of itself a bad thing, but it is in one of the two main variables that impact profitability. As DuPont taught us back in the 1920's, return on assets (ROA) equals the product of two factors: asset turnover and profit margins. Some profitable businesses have large profit margins to offset low turnover (jewelry, high-end brands, etc…); others like grocery stores or big box superstores like Walmart and Costco have very low margins but very high turnover.

But in the absence of decent inventory turns, profit margins must pick up the slack. And given that smaller competitors have both lower buying power (leading to lower gross margins) and smaller scale (leading to higher operating expenses as a percentage of sales, since fixed costs are spread across fewer locations), margins are much lower at smaller competitors.

3. **Sales per Square Foot**

This business generates a relatively modest amount of sales per square foot relative to many other retailers. It's not at the absolute low end, but definitely somewhere near the bottom quartile.



O'Reilly generates around $260 per square foot, which again, is likely much greater than many of its smaller mom & pop competitors. Again, this is another way that economies of scale benefit the larger players. O'Reilly can achieve close to 20% operating margins because of higher gross margins, but also because it can spread the fixed portion of its operating expenses across many different locations.

So sizable working capital requirements combined with low turnover and challenging margins for small stores are reasons why bigger is better in the auto parts retail business. Life is harder for the smaller competitors and there are real benefits for the larger businesses to acquire the smaller businesses. I think both of these factors will lead to a steadily consolidating industry over time.

Risk

Amazon is the biggest risk to the DIY segment of the business.

I don't see this as nearly as big of a risk in the commercial segment, where breadth of products on hand and the speed at which that product can reach the mechanic are much more of a driving factor for the mechanic than price.

But since DIY is still a majority (58%) of O'Reilly's business, this is not an insignificant risk for them. I think for most people fixing their own car, the price is probably the biggest factor (followed closely by speed and selection). I've done a number of price comparisons, and it seems that while Amazon isn't always the lowest price, they are lowest the vast majority of the time. As they get faster and faster at delivery, and as their auto parts selection continues to expand, I think they are going to be a real factor in this industry.

On the other hand, on yesterday's conference call the AZO CEO argued that there are a few differentiating factors between his business and Amazon (and since O'Reilly has the same basic model, it's applicable here also). Here is why AZO's CEO thinks his company can go head to head against Amazon's lower prices:

- Immediacy—people want their car fixed now. They don't want to wait a couple days for a part.
- Advice in store—the employees are knowledgeable, and can help you figure out what part you need.
- Core return—consumers can bring in their alternator core, for example, in exchange for a new alternator at a slightly discounted cost (that also has a refurbished core). There is apparently a sizable reverse supply chain in the after-market auto parts business.

I would agree that the service component of this business is valuable. Not everyone knows exactly what they need, and the employees in the stores are always very knowledgeable from my experience. I do think this is a factor that helps O'Reilly.

I am much more skeptical about the first point. I'm not sure that immediacy is as much of an Amazon deterrent as the AZO CEO believes. There are certainly some people who will drive over to the store to pick up a part that day, but with Amazon getting faster and faster delivery, this supposed advantage gets slimmer and slimmer for the auto parts retailers. If I can order my alternator today on Amazon and get it tomorrow, or even the day after tomorrow, and I can save $20, I'm likely going to do that.

Valuation

I started this post saying that I just wanted to mention some reasons why I like the business. Unfortunately, while I think ORLY is a very good business, I don't think the stock is "punch-card cheap" at the moment. The company will produce around $1 billion of free cash flow this year, and it will add another 200 or so stores to its footprint. The bottom line is growing at a healthy double digit pace when factoring in the steady buybacks, which are almost certain to continue. Shares outstanding have dropped from 142 million in 2010 (after the digestion of its last major acquisition) to 97 million today, and the company is retiring shares at a very fast pace.

This creates a nice tailwind, but at 25 times free cash flow, I think the stock is pricing in all of the good things I mention, and possibly not giving any of the risks (Amazon) any real possibility. I don't think Amazon is an existential risk for O'Reilly, but I do think they'll be a major competitor in this space. I think O'Reilly is a very good business, but I'd rather pay a lower price for the cash flow it produces, especially since there is a chance that competition might make it harder for the company to expand as quickly as it would like going forward.

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Thursday, December 6, 1951

The Security I Like Best

WARREN E. BUFFETT

Buffett-Falk & Co., Omaha, Nebr.

Government Employees Insurance Co.

Full employment, boomtime profits and record dividend payments do not set the stage for depressed security prices. Most industries have been riding this wave of prosperity during the past five years with few ripples to disturb the tide.

Warren E. Buffett

The auto insurance business has not shared in the boom. After the staggering losses of the immediate postwar period, the situation began to right itself in 1949. In 1950, stock casualty companies again took it on the chin with underwriting experience the second worst in 15 years. The recent earnings reports of casualty companies, particularly those with the bulk of writings in auto lines, have diverted bull market enthusiasm from their stocks. On the basis of normal earning power and asset factors, many of these stocks appear undervalued.

The nature of the industry is such as to ease cyclical bumps. Auto insurance is regarded as a necessity by the majority of purchasers. Contracts must be renewed yearly at rates based upon experience. The lag of rates behind costs, although detrimental in a period of rising prices as has characterized the 1945-1951 period, should prove beneficial if deflationary forces should be set in action.

Other industry advantages include lack of inventory, collection, labor and raw material problems. The hazard of product obsolescence and related equipment obsolescence is also absent.

Government Employees Insurance Corporation was organized in the mid-30's to provide complete auto insurance on a nationwide basis to an eligible class including: (1) Federal, State and municipal government employees; (2) active and reserve commissioned officers and the first three pay grades of non-commissioned officers of the Armed Forces; (3) veterans who were eligible when on active duty; (4) former policyholders; (5) faculty members of universities, colleges and schools; (6) government contractor employees engaged in defense work exclusively, and (7) stockholders.

The company has no agents or branch offices. As a result, policyholders receive standard auto insurance policies at premium discounts running as high as 30% off manual rates. Claims are handled promptly through approximately 500 representatives throughout the country.

The term "growth company" has been applied with abandon during the past few years to companies whose sales increases represented little more than inflation of prices and general easing of business competition. GEICO qualifies as a legitimate growth company based upon the following record:

Year—	Premiums Written	Policy-holders
1936---	$103,696.31	3,754
1940---	768,057.86	25,514
1945---	1,638,562.09	51,697
1950---	8,016,975.79	143,944

Of course the investor of today does not profit from yesterday's growth. In GEICO's case, there is reason to believe the major portion of growth lies ahead. Prior to 1950, the company was only licensed in 15 of 50 jurisdictions including D. C. and Hawaii. At the beginning of the year there were less than 3,000 policyholders in New York State. Yet 25% saved on an insurance bill of $125 in New York should look bigger to the prospect than the 25% saved on the $50 rate in more sparsely settled regions.

As cost competition increases in importance during times of recession, GEICO's rate attraction should become even more effective in diverting business from the brother-in-law. With insurance rates moving higher due to inflation, the 25% spread in rates becomes wider in terms of dollars and cents.

There is no pressure from agents to accept questionable applicants or renew poor risks. In States where the rate structure is inadequate, new promotion may be halted.

Probably the biggest attraction of GEICO is the profit margin advantage it enjoys. The ratio of underwriting profit to premiums earned in 1949 was 27.5% for GEICO as compared to 6.7% for the 135 stock casualty and surety companies summarized by Best's. As experience turned for the worse in 1950, Best's aggregate's profit margin dropped to 3.0% and GEICO's dropped to 18.0%. GEICO does not write all casualty lines; however, bodily injury and property damage, both important lines for GEICO, were among the least profitable lines. GEICO also does a large amount of collision writing, which was a profitable line in 1950.

During the first half of 1951, practically all insurers operated in the red on casualty lines with bodily injury and property damage among the most unprofitable. Whereas GEICO's profit margin was cut to slightly above 9%, Massachusett's Bonding & Insurance showed a 16% loss, New Amsterdam Casualty an 8% loss, Standard Accident Insurance a 9% loss, etc.

Because of the rapid growth of GEICO, cash dividends have had to remain low. Stock dividends and a 25-for-1 split increased the outstanding shares from 3,000 on June 1, 1948, to 250,000 on Nov. 10, 1951. Valuable rights to subscribe to stock of affiliated companies have also been issued.

Benjamin Graham has been Chairman of the Board since his investment trust acquired and distributed a large block of the stock in 1948. Leo Goodwin, who has guided GEICO's growth since inception, is the able President. At the end of 1950, the 10 members of the Board of Directors owned approximately one-third of the outstanding stock.

Earnings in 1950 amounted to $3.92 as contrasted to $4.71 on the smaller amount of business in 1949. These figures include no allowance for the increase in the unearned premium reserve which was substantial in both years. Earnings in 1951 will be lower than 1950, but the wave of rate increases during the past summer should evidence themselves in 1952 earnings. Investment income quadrupled between 1947 and 1950, reflecting the growth of the company's assets.

At the present price of about eight times the earnings of 1950, a poor year for the industry, it appears that no price is being paid for the tremendous growth potential of the company.

This is part of a continuous forum appearing in the "Chronicle," in which each week, a different group of experts in the investment and advisory field from all sections of the country participate and give their reasons for favoring a particular security.

Description

NVR is a homebuilder. Their operating model, which is unique (and which is described later), allows them to assume the least risk in the industry and produce returns that are the largest.

Homebuilders are generally dismissed because they're cyclical and interest-rate sensitive (really, though, which industry isn't?) and downturns inevitably leave homebuilders holding large inventories of unsold properties -- the unlevered builders then suffer large inventory writedowns while the levered builders go into bankruptcy. However, NVR's model will prevent it from suffering the same fate and, indeed, NVR will prosper in a downturn at the expense of the weaker builders.

Two of the most important facets to its operating model are:

(1) NVR acquires control of land inventory through options contracts. These contracts give NVR the right to buy finished lots from developers. NVR secures a supply of land for its homebuilding operations through the use of these options whereas other homebuilders purchase land outright and engage in land development. By avoiding that speculative practice of land purchase/development, and instead using options, NVR is able to control large blocks of land (years' worth) in its markets while employing less capital to do so. The lower capital requirements of this method translate into lower inventory risk and greater returns on capital.

(2) NVR pre-sells nearly all of its homes. Other homebuilders typically participate in some speculative construction. NVR does not. Before NVR begins construction, an order must be placed and a deposit made. This practice reduces risk and working capital requirements, which further enhance returns on capital.

In addition to NVR's superior model, consider the following:

-- Low valuation: NVR trades at a P/E of 8.6x trailing (7.1x 2001E EPS) and a TEV / EBITDA of 4.7x (trailing). TEV / (EBITDA - Capex) is 4.8x (trailing). TEV / FCF is 7.8x (trailing). I am defining FCF as Net income plus D&A minus Capex.

-- Backlog: NVR has a backlog of 5,765 ordered homes. These homes represent $1.49 billion of revenue. To put this into perspective, this is nearly three fiscal quarters of revenue. In addition, the homes in backlog carry higher gross margins than the ones in the historical results. All of this should translate into higher EPS. (Management says 2001 EPS should be just under $20 per share. In the short history that the company has provided guidance (previously they refused to) they have consistently been ridiculously conservative. Their 1Q results and the backlog indicate to me that the $20 EPS estimate continues to be the case).

-- High ROIC: The low capex nature of its business ($301 mil LTM homebuilding EBITDA versus consolidated LTM Capex of $5 mil) and the low working capital requirements of its model allow NVR to produce superior returns on invested capital: 45.3% in 2000, and 5-year average ROIC of 25%. Bonus fact: In 2000, NVR sold $325 mil more homes than it did in 1999, yet inventory (the bulk of a homebuilder's working capital requirement) increased only $11 million.

-- Intelligent allocation of excess capital: High returns on capital and excess cash flows are only useful if you have a management that is smart about deploying it. In NVR's case, management has chosen thus far to deploy that capital to buy back its own stock. Between 12/31/93 and 12/31/00 the company reacquired 13.5 mil shares. In the first quarter of 2001, NVR purchased another 0.85 mil shares For perspective, there are only 8.1 mil primary shares out today (I'm using primary shares to illustrate this but I use diluted shares for enterprise value calculations).

-- Homes a basic necessity: People will always need homes to live in. The process of building a home has not changed materially in decades. Neither of these statements is likely to change in the next year, the next 5 years, or even the next 20 years. There is minimal technological or obsolescence risk.

-- Dominant in its markets: NVR competes in 18 geographic markets. It is the #1 player in 10 of them. As for the remaining 8, it is usually #2 or #3 (always at least in the top 5). The rest are markets that NVR has just recently entered and will dominate with time.

-- Tax factors: The industry has indirectly enjoyed the benefits of a government subsidy in the form of tax deductible mortgage interest. Additionally, in the last few years, homebuyers no longer have to pay tax on the first $500k of capital gains on a home. This lowers the effective purchase price of a home for a consumer, increases the relative attractiveness of a home as an investment, and adds a little boost to demand for NVR's product.

NVR's profits and market dominance are all the more amazing when you remember that the results have been achieved without land development. NVR has margins better than its competitors despite the fact that other homebuilders benefit from the gross margin boost of speculative development in an inflationary environment.

Catalyst

The small number of shares outstanding occasionally creates large downward gaps. NVR's recent 25% drop is one such opportunity.

Also, share repurchases will continue to drive the stock. It's hard to overemphasize the magnitude of the repurchases or the wonderful track record of buybacks:

12/31/95: 15.21 (millions of shares outstanding)
12/31/96: 13.57
12/31/97: 11.09
12/31/98: 10.39
12/31/99: 9.17
12/31/00: 8.86
04/18/01: 8.14